STATEMENT OF
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BEFORE THE

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COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON

UNITED STATES COMPETITIVENESS IN THE GLOBAL FINANCIAL SERVICES INDUSTRY

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Thank you, Mr. Chairman and Committee Members for the opportunity to testify today on “America’s Capital Markets: Maintaining Our Lead in the 21st Century.” It is an honor and a privilege to be able to address the Committee.

My name is Lawrence Franko. I am the author of a recent study on U.S. Competitiveness in the Global Financial Services Industry, which was prepared for the Financial Services Forum of the College of Management at the University of Massachusetts Boston. The complete paper can be found on the Worldwide Web at www.financialforum.umb.edu/documents/franko .

This work is the latest in a series of articles and books I have written on Global Corporate Competition which go back to the 1970s and to my affiliation at that time with the Harvard Business School’s Multinational Enterprise Project.

U.S. Pre-eminence in Financial Services

The importance of American firms in the world's financial services industry is remarkable, and the position of U.S. enterprise in the most dynamic and rapidly growing segments of the industry is even more so.

With five percent of the world's population, and a quarter of its GDP, the United States has more than half of the capitalization and trading of the world's stock and bond markets. U.S. investment banks and brokerage houses dominate not just U.S., but international capital market transactions. Our money-management institutions and mutual funds manage well over half of the world's pension and personal financial assets. Consumer credit transactions are dominated worldwide by American brands. Far more than half of the world's hedge-fund, venture capital and private equity, and derivatives and risk management activities are conducted by American owned and managed firms.

These proportions would be yet higher were one to count not just U.S. owned institutions, but the major U.S. activities – some of which are of global scope in their own right – owned by foreign, predominantly European, financial firms.

While less impressive in the aggregate, the U.S. also has global leaders in traditional banking and insurance activities, several of whom spread internationally by piggy-backing on the historical expansion of U.S. multinational manufacturing and service firms. However, the regulatory balkanization and fragmentation of banking and insurance in the U.S. long inhibited the honing of competitive advantages that could translate into global dominance. U.S. global dominance in capital markets has arisen and accelerated after, and as a result of, the move toward new modes of financial intermediation, asset-gathering, and risk management in our domestic market.

Driving Forces

The driving forces of U.S. global pre-eminence in financial services and especially in capital markets activities are many, but several stand out:

1. The post-World War II prominence of the U.S. dollar in international transactions, and the development of trust in the U.S. dollar "brand."
2. The early U.S. recognition that encouragement should be given to funded pension plans, as opposed to relying primarily on government pay-as-you-go transfers.
3. The early development of a "securities culture," where regulation and competition interacted to produce a large domestic market in which publicly-quoted, professionally governed, transparency-oriented firms are the norm, rather than the exception.
4. Declining protection given to incumbent banks and insurance companies from capital markets competition, compared to other countries where dis-

intermediation was long inhibited and barriers to financial market alternatives remained high.

5. Institutions of higher education geared to producing the people with the knowledge and skills for capital market management positions.
6. The U.S. position as "first market" and others as "follower markets" for financial innovations from mutual funds, to hedge funds, to "big bangs," to public securities offerings on a large scale (floatations of previously family-owned or state firms), to providing rights for minority shareholders, and many others.

In broad summary, other countries eventually grew to have needs for capital market activities similar to those the U.S. had experienced earlier. They realized that they could not have economic growth and efficient capital allocation without importing competitive and regulatory practices developed first here. And, by the time they did so, many U.S. firms had developed unassailable strengths.

These strengths meant that even in non-U.S. locations where financial services may be concentrated – due to combinations of historical and customer agglomeration, or lighter or more deft regulation-- such as in the City of London, U.S. institutions would take the lead.

<u>Likely Futures</u>

There are many reasons why American financial, and especially capital markets institutions are likely to continue to expand their role in the world's financial services industry.

U.S. institutions have wide and deep first-mover advantages compared to their non-U.S. competitors. Not only have they pioneered the vast majority of the "alternatives to traditional banks," they have developed the technological, marketing, managerial, and worldwide network infrastructure to exploit those advantages.

Dis-intermediation has much further to go outside the U.S. The U.S. "past" of the replacement of banking by capital market and asset management institutions – at least in commercial, as opposed to retail financing – is Europe and Asia's future. Merge defensively as they might, nationally or across borders, traditional banks whose strengths are based on close ties to local and regional relationships are going to remain vulnerable to the competitive winds blowing from less-expensive capital market transactions. Retail customers may remain because of inertia and the psychic benefits of personalized hand-holding, but large and even small businesses who must compete in wider and wider economic spaces like the European Union and the Pacific Rim, will go to the most experienced midwives of low-cost capital market sources of funds.

The “securities culture” also has much further to go outside the United States. Significant reliance on “pay-as-you-go,” un-funded government pension plans is simply not viable in the 21st century. Alternatives must be found, and no one has yet found a better one than the funding and investing of savings for retirement as pioneered in the U.S. There are abundant opportunities for U.S. asset managers.

Regulatory and Competitive Implications

The great global success of U.S. capital markets institutions rests on at least four domestic pillars. Our home market is unique in the world because of:

- The intensity of competition, within and especially across financial services industry segments.
- The depth and size of our markets, with multitudinous varieties of securities and instruments.
- Innovation and skills, and perhaps especially,
- The reputation, transparency, and probity of the leading firms and actors in the market, including the reliability of the U.S. dollar and institutional “brand.”

Translated into the mission of this Committee, I would suggest two overarching guidelines for the future.

We should remember goals, even when preoccupied by details. Congress makes laws, and many laws are highly detailed and complex. Day-to-day petitions pertaining to those laws seem largely to center on arguments over whether and how S.E.C., Sarbanes-Oxley, Patriot Act and other rules and regulations might be lightened, changed, or strengthened. Ultimately, however, maintaining and strengthening the U.S. global capital market position means maintaining our reputation. Our ‘‘brand” is not just transactions efficiency, knowledge and skill. It is also honesty, transparency, and good corporate and capital market governance. We cannot gain the benefits of this reputation without incurring some costs.

Regulation should also look out for the interests of consumers, and share and bond-stakeholders, not for those of firms and managers who may wish to entrench themselves against competition. Had our “big bang” not occurred first, or had our banks been able to continue to shut out out-of-state or non-bank competition, we would not have the thriving capital-market actors we do today. Firms hone their global competitive skills by first competing at home. Regulation that protects today weakens firms in the long run. We should promote the future, not the past.

Thank you for your interest and attention.